

Message Text

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SUBJECT: SPANISH ECONOMIC PROGRAM ANOTHER KEY STEP IN THE REFORM
OF THE FINANCIAL SYSTEM

REF: (A) MADRID 5632 (B) MADRID A-98

1. SUMMARY THE BANK OF SPAIN INITIATED SEPTEMBER 7 AN
AUCTION SYSTEM FOR PROVIDING CREDITS TO PRIVATE BANKS IN
NEED OF INCREASED LIQUIDITY. IT HAS BEEN THE PRACTICE HERE
THAT THE BANK OF SPAIN ALLOCATES CREDIT DAILY TO PRIVATE
BANKS AT FIXED, LOW RATES FOR TERMS RANGING FROM ONE DAY TO
SEVERAL MONTHS. THESE CREDITS ARE BOTH THE CHIEF TOOL FOR
REGULATING THE MONEY SUPPLY AND THE CHIEF MEANS FOR MEETING
THE CONSTANTLY GROWING LIQUIDITY NEEDS OF PRIVATE BANKS
(SEE MADRID A-98). WITH THIS NEW CHANOE, BIWEEKLY BANK
OF SPAIN AUCTIONING OF SHORT TERM MONEY BEGAN AND WILL
GRADUCALLY REPLACE THE ALLOCATION SYSTEM. SINCE THE
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SPANISH GOVERNMENT IS REDUCING MONEY SUPPLY GROWTH
BY REDUCING "DROP BY DROP" ALLOCATION OF CREDITL AND
SINCE PRIVATE BANKS ARE IN GREAT NEED OF CENTRAL
BANK SUPPLIED LIQUIDITY, THE FIRST AUCTION RESULTED IN
INTEREST RATES (12.75) PERCENT AND HIGHER) MUCH HIGHER
THAN DROP BY DROP RATES (7 OR 8 PERCENT). THIS
ACTION IS AN IMPORTANT PART OF THE GOVERNMENT'S PRO-

GRAM TO RATIONALIZE AND REFORM THE SPANISH FINANCIAL SYSTEM. END SUMMARY.

2. IF ALL GOES AS PLANNED, AN AUCTION SYSTEM WILL GRADUALLY DISPLACE "DROP-BY-DROP" AS THE BANK OF SPAIN'S CHIEF MONEY SUPPLY TOOL (SEE MADRID A-98). AND PUBLICLY OWNED SPANISH SAVINGS BANKS, WHICH ARE NOW BEING INTEGRATED INTO THE PRIVATELY OWNED COMMERCIAL BANKING SYSTEM, WILL ALSO HAVE ACCESS TO THE AUCTIONED MONEY. UNTIL NOW THE BANK OF SPAIN'S "DROP-BY-DROP" HAS MADE FIXED-RATE SHORT TERM MONEY AVAILABLE TO PRIVATE BANKS BY A DAILY ALLOCATION BASED ON BANK SIZE. ANY ADDITIONAL LIQUIDITY WAS OBTAINED ON A SMALL, WILDLY FLUCTUATING INTERBANK MONEY MARKET. REPLACING "DROP-BY-DROP" LOANS WITH AN AUCTION SYSTEM WILL MAKE MORE EFFICIENT AND EQUITABLE THE DISTRIBUTION OF LIQUIDITY IN A NATIONAL FINANCIAL SYSTEM LONG CHARACTERIZED BY ISOLATION FROM MARKET FORCES. "DROP-BY-DROP" LOANS NOW CONSTITUTE ROUGHLY 10 PERCENT OF PRIVATE BANK RESERVES, ALTHOUGH THE PROPORTION HAS BEEN SHRINKING RAPIDLY AS THE BANK OF SPAIN SLOWS MONEY GROWTH IN THE FACE OF INCREASED LIQUIDITY DERIVING FROM THE EXPENDITURES OF FOREIGN TOURISTS. THE AUCTION SYSTEM IS ONLY ONE OF MANY COMPLEX CHANGES BEING MADE TO STRENGTHEN THE ROLE OF MARKETS IN THE FINANCIAL LIMITED OFFICIAL USE

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SYSTEM AND THROUGHOUT THE ECONOMY.

3. THE GOVERNMENT'S SETTING OF ALL INTEREST RATES FOR SAVERS AND LENDERS HAS BEEN A MAJOR WEAKNESS OF THE SPANISH FINANCIAL SYSTEM. AT FIRST THE FIXED RATES MERELY GUARANTEED BANKS A FAT PROFIT, BUT WITH THE HIGH PRICE INFLATION OF RECENT YEARS THE AIWLB IC FOW INTEREST RATES HAVE MADE AN EQUITABLE DISTRIBUTION OF CREDIT IMPOSSIBLE AND HAVE CREATED A DISINCENTIVE FOR SAVERS AND A CONSEQUENT SHARP FALL IN SAVINGS. THE GOVERNMENT'S ECONOMIC PROGRAM (SEE MADRID 5632) THEREFORE CONTAINED PROPOSALS FOR USING MARKETS TO REFORM AND REINVIGORATE THE FINANCIAL SYSTEM. AS A RESULT, IN ADDITION TO CREATING THE NEW LIQUIDITY AUCTIONING SYSTEM, THE GOVERNMENT HAS ALREADY BEGUN REDUCING MONEY GROWTH, INCREASED THE BANK OF SPAIN BASIC INTEREST RATE. ELIMINATED GOVERNMENT INTEREST RATE FIXED FOR

PERIODS LONGER THAN ONE YEAR AND ENDED ALL FEES ON BANK FEES. IN ADDITION, CONTROLS ON THE INVESTMENT OF BANK RESERVES HAVE BEEN RELAXED, AND CONSIDERABLE

PROGRESS HAS ALREADY BEEN MADE TOWARDS FULLY INTEGRATING
THE SPANISH SAVINGS BANKS INTO THE COMMERCIAL
BANKING SYSTEM.

4. THE CREATION OF THE LIQUIDITY AUCTION SYSTEM AND
OTHER MEASURES TAKEN PREVIOUSLY WILL DISTRIBUTE
MONEY MORE EFFICIENTLY. NOW, AT A PRICE, LIQUIDITY
HUNGRY BANKS BANKS AND BORROWERS WILL HAVE A BETTER CHANCE
TO OBTAIN THE MONEY THEY NEED EVEN IF THEY ARE NOT
PARTICIPANTS IN THE "PRIVILEGED FINANCIAL CIRCUITS"
WHICH HAVE ARISEN FROM ARTIFICIALLY CHEAP MONEY.
THE FULL INTEGRATION INTO THE COMMERCIAL BANKING
SYSTEM OF SPANISH SAVINGS BANKS, AND EVENTUALLY THE
ESTABLISHMENT OF MORE FOREIGN BANKS, WILL SPUR THE
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FINANCIAL COMPETITION. THE PROGRAMMED REDUCTION
OF GOVERNMENT CONTROL OF BANK RESERVES WILL SERVE
THE SAME PURPOSE. (IN THE TRANSITION TO SCARER
BUT BETTER DISTRIBUTED MONEY, EXPORTERS WILL CONTINUE
TO RECEIVE PREFERENTIAL TREATMENT FOR BROADER
POLICY REASONS. IN FACT, FINANCIALLY SOUND SMALL
BUSINESSES MAY ACTUALLY RECEIVE NEW SPECIAL TREATMENT,
IN THE FORM OF OFFICIAL CREDIT AND GOVERNMENT
CREDIT GUARANTEES.)

5. COMMENT: WE CONTINUE TO BE IMPRESS WITH THE
COMPREHENSIVENESS OF THE GOVERNMENT'S ECONOMIC
STRATEGY. FINANCIAL REFORMS, WHILE SEEMINGLY LESS
DRAMATIC INFLATION FIGHTERS THAN OTHER MEASURES,
ARE A GOOD EXAMPLE. WHEREAS THE LEFTIST POLITICAL
PARTIES TALKED BEFORE THE JUNE ELECTIONS OF NATIONALIZING
SSPAIN'S MAJOR BANKS, THE SUAREZ COALITION
POINTED OUT THAT BETTER RESULTS COULD BE HAD BY
CHANGING THE RULES WITHIN WHICH BANKS ACT. SPAIN'S
PRINCIPAL ECONOMIC POLICY MAKER, SECOND VICE
PRESIDENT FUENTES, HAS BEEN BOTH A PROFESSOR OF
ECONOMICS AND THE CHIEF ADVISOR TO SPANISH SAVINGS
BANKS; HIS APPROACH TO THE FINANCIAL REFORMS NOW
BEING IMPLEMENTED HAS REFLECTED BOTH HIS ACADEMIC
TRAINING AND HIS KNOWLEDGE OF CREDIT INSTITUTIONS.
A SEPARATE CABLE WILL DESCRIBE THE RESULT OF THE
SLOWER MONEY GROWTH BEING ORCHESTRATED BY THE
BANK OF SPAIN.EATON

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